No. 12826

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

LAWRENCE BARKER,

Appellant,

vs.

UNITED STATES OF AMERICA,

Appellee.

Appeal from the United States District Court for the for the Southern District of California.

BRIEF FOR THE UNITED STATES.

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TOPICAL INDEX

INDEX TO APPENDIX

TABLE OF AUTHORITIES CITED.

CASES. PAGE

STATUTES

MISCELLANEOUS

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Opinion Below.

The findings of fact and conclusions of law of the District Court [R. 140-146] are unreported. The separate memorandum opinion of the District Court [R. 136-138] is unreported.

Jurisdiction.

This appeal involves federal income and victory taxes for the taxable year 1943. The taxes in question were paid on or before March 15, 1944. [R. 144.] Claim for refund was filed March 15, 1947 [R. 9-16], and the Commissioner of Internal Revenue rejected this claim July 27, 1948. [R. 17.] Within the time provided in Section 3772 of the Internal Revenue Code and on April 27, 1949, taxpayer brought an action in the District Court for recovery of a portion of the taxes paid. [R. 3-8.] Jurisdiction was conferred on the District Court by 28 U. S. C., Section 1340. The judgment was entered October 24, 1950. [R. 146-147.] Within sixty days and on December 18, 1950, a notice of appeal was filed. [R. 148.] Jurisdiction is conferred on this Court by 28 U. S. C., Section 1291.

Questions Presented.

1. Whether the transactions whereby taxpayer exchanged shares of common stock in Barker Bros., Inc., of California, which he originally owned, for common stock in Barker Bros., Inc., of Delaware and then exchanged his common stock in the latter corporation, or his right to receive that common stock for common stock in Lawrence Barker, Incorporated, gave rise to a gain or loss that may be recognized for federal income tax purposes within the meaning of Sections 112(b)(5) and 113(a)(6) of the Internal Revenue Code.

2. Following from question number (1), whether certain shares in Lawrence Barker, Incorporated, subsequently sold by taxpayer, had a cost or other basis for determining gain or loss upon their disposition.

Statutes and Regulations Involved.

These appear in the Appendix, *infra*.

Statement.

The facts were found as follows by the District Court [R. 141-144]:

Lawrence Barker, the taxpayer herein, and Charles Lawrence Barker, C. Lawrence Barker and C. L. Barker are one and the same person. [R. 141.]

On October 19, 1923, and up to and including December 28, 1923, Barker Bros., Inc., was a California corporation, engaged in the business of selling furniture and house furnishings. Its outstanding capital stock consisted of 5,750 shares of voting preferred stock, having a total par value of $575,000, and 17,894.35 shares of common stock, having a total par value of $1,789,435. [R. 141.]

On October 19, 1923, and up to and including December 28, 1923, the common stock of Barker Bros., Inc. of California was owned as follows [R. 142]:

Stockholder	No. of Shares
Charles Lawrence Barker, as Executor of the Estate of W. A. Barker, deceased	3,418.19
Pauline Barker	1,660
Lawrence Barker, individually	1,841.50
F. K. Colby, Trustee	300
Lawrence Barker, Trustee	960
C. H. Barker) C. A. Barker) Erle P. Barker)	8,187.69
J. W. Beam, Trustee for certain employees of Barker California	1,526.97
Total	17,894.35

Prior to December 28, 1923, the cost or other basis for determining gain or loss on the sale or disposition of the shares of stock of Barker Bros., Inc. of California in the hands of the following stockholders of Lawrence Barker, Inc., was [R. 142]:

Stockholder	No. of Shares	Basis
Estate of W. A. Barker	3,368.19	$753,598.84
Estate of W. A. Barker	50	9,239.85
Pauline Barker	1,660	163,577.19
Lawrence Barker	1,841.50	235,031.57
Pauline Barker	1,660	163,577.19
Lawrence Barker	1,841.50	235,031.57
Lawrence Barker, Trustee	960	126,345.26
F. K. Colby, Trustee	300	38,289.15

On December 28, 1923, a corporation was organized under the laws of Delaware and also known as Barker Bros., Inc. [R. 143.]

On December 28, 1923, the holders of all the common stock of Barker Bros., Inc. of California agreed to and did exchange all of the shares of its common stock for all of the shares of the common stock of the newly organized corporation (Barker Bros., Inc. of Delaware), and were in control of the latter corporation immediately following the exchange with the same proportionate stock interests that they had previously held in the California corporation. [R. 143.]

On December 22, 1923, a corporation known as Lawrence Barker, Incorporated, had been organized under the laws of the State of California by the taxpayer and a group of the holders of common stock in Barker Bros., Inc. of California, who had associated themselves with him. The persons in this group directed that the shares of common stock in Barker Bros., Inc. of Delaware, to which they were entitled, be issued not in their names but in the name of Lawrence Barker, Incorporated. This direction was carried out and Lawrence Barker, Incorporated, received the shares of common stock in Barker Bros., Inc. of Delaware, to which taxpayer and his associates were entitled in exchange for all of its own common stock which was, on December 28, 1923, issued to taxpayer and his associates in the same proportions that they were entitled to receive stock in Barker Bros., Inc. of Delaware. Taxpayer and his associates were in control of Lawrence Barker, Incorporated, immediately after this exchange. [R. 143-144.]

On December 30, 1943, taxpayer sold thirty shares of the common stock of Lawrence Barker, Inc., which

he had acquired by the exchange set out above in Finding No. VII for the sum of $5,000. [R. 144.]

On March 15, 1944, taxpayer filed his income tax return for the calendar year 1943 with the Collector of Internal Revenue for the Sixth Collection District of California and paid to such Collector on or before March 15, 1944, the entire tax liability shown on return. The taxpayer included in his 1943 tax return as income from capital gain the entire amount of $5,000 received by him as the sales price of his thirty shares of the common stock of Lawrence Barker, Inc., as previously mentioned herein. [R. 144.]

Additional facts were stipulated. [R. 21-134.] To give a more complete picture than that found in the District Court's findings of fact, the following merit notice:

The transactions involved herein resulted from an agreement to reorganize the corporate affairs of Barker California. [R. 45-56.] This agreement adopted a plan of reorganization. [R. 51-56.] As found by the District Court, the plan contemplated the exchange of stock in Barker California for Barker Delaware stock. It also contemplated the sale to Marshall Field, Glore, Ward & Company (hereinafter referred to as Bankers) of certain stock in Barker Delaware, and the granting of an option to Bankers to purchase further Barker Delaware stock. [R. 55-56.]

In pursuance of the plan, 50,892 shares of Barker Delaware stock were issued to the majority stockholders of Barker California, in the same proportion as they held

stock in California, in exchange for their Barker California common stock. [R. 26.] The Lawrence Barker interests transferred their Barker California stock to Barker Delaware and, pursuant to a letter so directing, their proportionate interest in Barker Delaware (43,870 shares) was transferred to Lawrence Barker, Inc. The Beam interests similarly received 935 shares of Barker Delaware. [R. 27.] In return for their having caused the transfer of Barker Delaware stock to Lawrence Barker, Inc., the Lawrence Barker interests received 19,997 shares of stock in Lawrence Barker, Inc. [R. 27-28, 85-86.]

As the reorganization plan contemplated [R. 53-55], the common stock holdings of Lawrence Barker, Inc., were transformed into holdings of 20,870 shares of Barker Delaware first preferred and 23,000 shares of second preferred. [R. 29.] The common stock holdings of the C. H. Barker interests were transformed into 100,000 shares of no par common stock. The preferred stock of Barker California was redeemed and returned and the assets of that company transferred to Barker Delaware. [R. 33-34.]

Of the 20,870 shares of Barker Delaware first preferred now held by Lawrence Barker, Inc., the latter corporation was obligated to transfer 10,870 shares to Bankers. [R. 58.] This was done [R. 30], leaving 10,000 shares of Barker Delaware first preferred in the hands of Lawrence Barker, Inc. The reorganization agreement contemplated [R. 46] that the Lawrence Barker interests might sell these remaining 10,000 shares to Bankers. Accordingly, the agreement with Bankers gave Bankers an option to purchase these shares at a stated price. [R. 58.] This option was exercised. [R. 30-32.]

Summary of Argument.

Under the applicable law, the Revenue Act of 1921, the shares of stock in Lawrence Barker, Inc., sold in 1943 by taxpayer, took their basis from taxpayer's Barker Delaware stock, in exchange for which he had received the Lawrence Barker, Inc., stock, and which in turn took its basis from taxpayer's Barker California stock.

Taxpayer acquired his Lawrence Barker, Inc., stock as a result of a tax-free exchange, since he received it in exchange for Barker Delaware stock, receiving the same proportionate interest in property received as he had had in the property transferred, and since he and his co-transferors of Barker Delaware stock controlled Lawrence Barker, Inc., immediately after the transfer.

Taxpayer acquired his Barker Delaware stock in a tax-free exchange for his stock in Barker California. Both Barker Delaware and Barker California were parties to a reorganization, and within the requirement of the statute, there was a plan of reorganization. At the completion of the plan, Barker Delaware owned all the assets formerly owned by Barker California. The former majority stockholders of Barker California became the majority stockholders in Barker Delaware. There had been, within the terms of the statute, the acquisition by one corporation of all the stock and all the assets of another corporation, and hence a complete compliance with the definition of a reorganization contained in the statute. The continuing majority stock interest of the majority stockholders provides the requisite continuity of interest. The creation of Lawrence Barker, Inc., to hold the Barker Delaware stock of the Lawrence Barker interests does not change the tax-free character of the exchange of Barker California for Barker Delaware stock. This case is to be distinguished from those in which assets are transferred to a subsidiary

and the original transferors receive stock in the parent, or where stock is transferred to the parent and they receive stock in a subsidiary. The presence of Lawrence Barker, Inc., is not comparable to such situations because of the obvious continuity if not identity of interest between the Lawrence Barker interests and Lawrence Barker, Inc. Thus, it is unimportant that Lawrence Barker, Inc., is not to be described as a party to the reorganization. Moreover, the reorganization scheme in no way required the participation of Lawrence Barker, Inc.; its creation was important only to the purposes of the several individuals composing the Lawrence Barker interests.

In the alternative, taxpayer acquired his stock in Lawrence Barker, Inc., in a tax-free organization, because the stock was acquired as the result of a transfer to a corporation for its stock, after which the original transferors controlled the corporation. The stockholders of Barker California transferred property to Barker Delaware, and received in Barker Delaware controlling stock within the definition of the statute in the same proportion as their interests in the property transferred to it. The Lawrence Barker interests merely chose to hold their stock through the medium of Lawrence Barker, Inc. The obligation of the Lawrence Barker interests to transfer stock in Barker Delaware to Bankers does not affect this transfer, for this was merely a step in the liquidation of the Lawrence Barker interests' holdings, unrelated to the reorganization of Barker California. Thus, the presence of such obligations does not affect the control by the former California stockholders of Barker Delaware immediately after their transfer of California stock to it. In any event, only a fraction of the Barker Delaware stock sold to Bankers was included in the obligation; other shares were included in an option agreement. And an option agreement is not a binding contract to sell; therefore it cannot be considered to affect control.

ARGUMENT.

The Taxpayer's Shares in Lawrence Barker, Inc., Which He Sold in 1943, Take Their Basis From Shares in Barker Delaware Which He Transferred to Lawrence Barker, Inc., in Exchange for Shares Therein.

In 1943 taxpayer sold thirty shares of the stock of Lawrence Barker, Inc., and this case presents the issue as to taxpayer's basis for computing gain or loss on that sale. This stock he had received in 1923, in exchange for directing the transfer to Lawrence Barker, Inc., of stock in Barker Delaware. He had become entitled to the Barker Delaware stock by virtue of transferring to that corporation his portion of the stock of Barker California, which was the predecessor corporation to Barker Delaware. That the shares received by taxpayer from Lawrence Barker, Inc., were received in an exchange upon which no gain or loss should be recognized cannot seriously be questioned, and hence the basis of these shares is the same as the basis of the property exchanged for them. The substantial question in the case therefore is, as we shall show, whether the Barker Delaware stock (exchanged for the Lawrence Barker, Inc., stock) was acquired by the taxpayer in a non-taxable exchange.

Under Section 113(a) of the Internal Revenue Code (Appendix, *infra*), for determining gain or loss the basis of property is to be considered the cost of that property. But there are exceptions to this general statutory rule. For example, Section 113(a)(6) of the Code provides that if property is acquired in an exchange upon which, under Section 112(b) no gain or loss is recognized, the basis of the property sold shall be the same as the basis of the property originally exchanged for it. Prior Revenue Acts

have contained similar provisions. For purposes of this case, the relevant sections are to be ascertained by reference to Section 113(a)(12) and (16) of the Code. (Appendix, *infra.*)

Section 113(a)(12) provides in the case of property acquired after February 28, 1913, in any taxable year beginning prior to January 1, 1934, where the basis thereof for purposes of the Revenue Act of 1932 was prescribed by Section 113(a)(6) (Appendix, *infra*), (7), or (9) of that Act, then the basis shall be the basis therein prescribed in the Revenue Act of 1932. Section 113(a)(16) provides in the case of similar property, acquired in any taxable year prior to January 1, 1936, where the basis for the purposes of the Revenue Act of 1934 was prescribed by Section 113(a)(6) (Appendix, *infra*), (7), or (8) of such Act, then the basis shall be the basis therein prescribed in the Revenue Act of 1934.[1]

Section 113(a)(6) of both the 1932 and 1934 Acts provides that where property is acquired upon exchanges described in Section 112(b) of such Acts (Appendix, *infra*), the basis of the property acquired shall be the same as the basis of the property exchanged, decreased in the amount of any money received by taxpayer and increased in the amount of gain or decreased in the amount of loss to such taxpayer that was recognized upon such an exchange under the law applicable to the year in which the exchange was made. Thus we are concerned herein primarily with Section 202(c)(2) and (3) of the Revenue Act of 1921,

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[1]The seemingly conflicting provisions of Section 113(a)(12) and (16) are explained by the fact that the Revenue Act of 1934 made changes with respect to certain kinds of reorganizations. As a result, pre-1934 reorganizations are examined in the light of the law prior to the 1934 changes. See 3 Mertens, Law of Federal Income Taxation, Sec. 21.80.

which was in effect in 1923 when the events herein took place, which contained, so far as material here, substantially the same provisions as Section 112(b) of the Revenue Act of 1934 referred to by the District Court, and Section 112(b) of the Revenue Act of 1932 referred to by the taxpayer. (Br. 19.)

Section 202(c)(2) of the Revenue Act of 1921 (Appendix, *infra*), provides that no gain or loss shall be recognized when in the reorganization of one or more corporations a person receives in place of any stock or securities owned by him, stock or securities in a corporation a party to or resulting from such reorganization. It defines a reorganization as including (1) a merger or consolidation, including the acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation, or of substantially all the properties of another corporation, (2) a recapitalization, or (3) a mere change in identity, form, or place of organization of a corporation. Section 202(c)(3) of that Act (Appendix, *infra*) provides that no gain or loss shall be recognized where one or more persons transfer any property to a corporation and immediately thereafter are in control thereof, providing in the case of two or more persons the stock or securities received from such corporation are in substantially the same proportion as their interests in the property before transfer. It defines control as the ownership of at least 80 per cent of the voting stock and at least 80 per cent of the total number of shares of all other classes of stock of the corporation.

The District Court held that taxpayer received his stock in Lawrence Barker, Inc., as a result of an exchange described in Section 112(b)(5) of the Revenue Act of 1934.

Accordingly, it determined taxpayer's basis per share as $52.18, a figure apparently derived with reference to the cost basis of the original Barker California stock held by him. Therefore, it found that taxpayer had realized a capital gain upon the sale of his stock, albeit a smaller gain than had originally been reported on taxpayer's income tax return for 1943. Accordingly, judgment was entered in taxpayer's favor [R. 146-147], but for a smaller amount than the amount sought in taxpayer's complaint. [R. 8.]

It is our position that taxpayer received his Lawrence Barker, Inc., stock as a result of a transfer which qualifies under Section 202(c)(3) of the Revenue Act of 1921 and Section 112(b)(5) of the Revenue Acts of 1932 and 1934 as an exchange upon which no gain or loss is to be recognized; that accordingly this stock took the same basis as that of the property exchanged therefor; that the property exchanged for the Lawrence Barker, Inc., stock, namely, shares or right to shares of Barker Delaware, was acquired by taxpayer in a non-taxable exchange for shares of Barker California and hence took the basis of the Barker California stock.

A. Taxpayer Acquired His Lawrence Barker, Inc., Stock as a Result of a Tax-free Exchange Within the Meaning of Section 202(c)(3) of the Revenue Act of 1921 and Section 112(b)(5) of the Revenue Acts of 1932 and 1934.

Lawrence Barker, Inc., certain stock in which was sold by taxpayer during the taxable year 1943, was organized on December 22, 1923, by the Lawrence Barker interests, a closely knit family group, for the specific purpose of holding certain shares of stock which the Lawrence Barker interests were to receive upon the reorganization or merger

of Barker California into Barker Delaware. On December 28, 1923, in exchange for the shares of common stock in Barker Delaware to which taxpayer and his associates (known as the Lawrence Barker interests) were entitled, Lawrence Barker, Inc., issued to taxpayer and his associates all but three of the 20,000 shares of its common stock, in the same proportion that those interests were entitled to receive stock in Barker Delaware. Immediately after this exchange, the Lawrence Barker interests, by virtue of holding 19,997 shares of Lawrence Barker, Inc., common, the only outstanding stock, controlled that corporation.

This transaction clearly comes within the terms of Section 202(c)(3) of the Revenue Act of 1921 and Section 112(b)(5) of the Revenue Acts of 1932 and 1934. These sections provide that where a person or persons transfer property (in this case stock in Barker Delaware) to a corporation and receive therefrom stock or securities in the same proportion as their interest in the property transferred, and where they then control the corporation by virtue of holding 80 per cent of the outstanding voting stock and 80 per cent of all other classes of stock in the corporation, then the transaction is one upon which no gain or loss is recognized. The transaction herein is the simplest kind of transfer under the statute. See Treasury Regulations 62, Art. 1566(c), Example (1). (Appendix, *infra.*) Thus the stock in Lawrence Barker, Inc., which was received by the Lawrence Barker interests takes as its basis the basis of the property transferred to the corporation, the basis of the Barker Delaware stock. Section 113(a)(6) of the Revenue Acts of 1932 and 1934.

B. Taxpayer Acquired His Barker Delaware Stock as a Result of a Tax-free Reorganization, Within the Meaning of Section 202(c)(2) of the Revenue Act of 1921 and Section 112(b)(3) of the Revenue Act of 1932.

As noted above, Section 202(c)(2) of the Revenue Act of 1921 as well as Section 112(b)(3) of the Act of 1932 provides for the nonrecognition of gain or loss if, pursuant to a plan of reorganization, stock or securities in a corporation a party thereto are exchanged solely for stock or securities in another corporation a party to the reorganization. Section 112(i)(1) of the Revenue Act of 1932 (Appendix, *infra*) defines a reorganization to be—

> (A) a merger or consolidation (including the acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation, or substantially all the properties of another corporation) * * *, or (C) a recapitalization, or (D) a mere change in identity, form, or place of organization, however effected.[2]

Section 112(i)(2) describes a party to a reorganization as including a corporation resulting from a reorganization and includes both corporations where one acquires at least a majority of the voting stock and at least a majority of all other classes of stock of another corporation.

Under the facts of this case, it is clear that both Barker California and Barker Delaware are to be considered parties to a reorganization under Section 112(i)(2), for there is no dispute that Barker Delaware acquired all the Barker

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[2]This quoted definition of "reorganization" likewise was contained in Section 202(c)(2) of the Revenue Act of 1921, Chap. 136, 42 Stat. 227.

California common stock, redeemed and retired all the Barker California preferred, and acquired all the assets of the old corporation. Thus at the completion of the plan Barker Delaware owned all of the assets formerly owned by Barker California and all the stock of all classes of Barker California. The C. H. Barker interests, which had owned a majority stock interest in Barker California, owned the majority stock interest in Barker Delaware which had been received in exchange for their Barker California stock.

With respect to Barker California, Barker Delaware and the C. H. Barker interests which held the majority stock interest in the old corporation and which acquired in exchange therefor a majority interest in the new corporation, there can be no serious question that a nontaxable reorganization and exchange within the purview of the revenue laws occurred. There was clearly the acquisition by one corporation of all the stock and all the assets of another corporation and hence a literal and complete compliance with the definition of "reorganization."

The continued participation in the new corporation by the majority interests of the old, without more, would provide the necessary continuity of interest required by the decisions of *Pinellas Ice Co. v. Commissioner,* 287 U. S. 462, and *Helvering v. Minnesota Tea Co.,* 296 U. S. 378. Indeed, the identity of Barker California as a continuing business enterprise was basically unchanged, although its state of incorporation and stock structure were changed. The real change effected was to change the stock structure from outstanding capital stock of 5,750 shares of voting preferred and 17,894.35 shares of common [R. 22] to outstanding capital stock of 25,000 shares of first preferred, 23,935 shares of second preferred, and 100,000 shares of

no par common. [R. 34.] The procedural steps merely enabled the new corporation as recapitalized to acquire the assets of the old. *Cf. Helvering v. Limestone Co.,* 315 U. S. 179, 185.

There can be no contention that there was not a reorganization plan. The plan was full and complete [R. 51-56] and its aims were effected. It was agreed upon for the purpose of reorganizing Barker California and readjusting the several stock interests [R. 45, 51] and the plan was consummated. [R. 33-34.] We do not contend in this respect that Lawrence Barker, Inc., was a party to the reorganization. But such a contention is not necessary to the application of Section 112(b)(3). The participation of Lawrence Barker, Inc., did not change the ultimate purpose of the transactions herein—to exchange ownership of shares in Barker California for ownership of shares in Barker Delaware. It is that exchange which constitutes the real issue herein.

We have shown that if the series of transactions involved in the plan so far as it pertained to the reorganization of Barker California should be examined in the light of the ultimate result, examining the termination only in the light of the commencement, without substantial attention to the procedural steps in between (*e. g., Halliburton v. Commissioner,* 78 F. 2d 265 (C. A. 9th); *S. Klein on the Square, Inc. v. Commissioner* (C. A. 2d), decided April 4, 1951 (1951 P-H Fed. Tax Serv., par. 72,322)), the critical exchanges were nontaxable.

The formation by the Lawrence Barker interests of Lawrence Barker, Inc., as a holding company for their Barker Delaware stock did not destroy the otherwise nontaxable exchange of Barker California stock for Barker Delaware stock. *Bus & Trans. Corp. v. Helvering,* 296

U. S. 391; *Groman v. Commissioner,* 302 U. S. 82; *Helvering v. Bashford,* 302 U. S. 454; *Lawrence v. Commissioner,* 123 F. 2d 555 (C. A. 7th); *Anheuser-Busch, Inc. v. Helvering,* 115 F. 2d 662 (C. A. 8th), certiorari denied, 312 U. S. 699, are inapplicable. These cases all involved situations where a corporation or its stockholders, after the completion of a plan of reorganization, owned in place of transferred assets stock in some corporation other than the corporation to which the transferred assets were ultimately conveyed. That is to say, the assets were either transferred to a subsidiary corporation and the original transferors received stock in the parent, or the assets were transferred to the parent and the original transferors received stock in the subsidiary.

We consider the facts herein distinguishable from such situations. Lawrence Barker, Inc., was not a subsidiary either of Barker California or Barker Delaware. It was a convenient holding company for the securities of the Lawrence Barker interests. To apply the cases just noted would ignore what, for lack of a better definition, might be described as the intra-identity of Lawrence Barker, Inc., and the individuals composing Lawrence Barker interests. Because of the close family relationship involved, Lawrence Barker, Inc., should be treated more as a wholly owned personal corporation (*cf. Higgins v. Smith,* 308 U. S. 473), rather than as a component of a corporate pyramid. Where a stockholder holds stock in the parent of a wholly-owned subsidiary, his control of the subsidiary is admittedly indirect and elusive, and it may be convincingly argued that there is no continuity of interest between the individual and the subsidiary. *Bus & Trans. Corp. v. Helvering, supra.* But there is a clear continuity, if not identity of interest, where the Lawrence Barker interests hold shares in Barker California directly and where they

hold similar shares in the new Barker Delaware through the device of a corporation whose only function is to hold securities. This is not to say that Lawrence Barker, Inc., is the *alter ego* of the Lawrence Barker interests. *Cf. Schuh Trading Co. v. Commissioner,* 95 F. 2d 404, 411 (C. A. 7th). Nor do we seek to ignore a corporate entity. But the relationship is so peculiarly close between the Lawrence Barker interests and Lawrence Barker, Inc., that substance is ignored if Lawrence Barker, Inc., is merely described as not a party to the reorganization, and if therefore it be said that taxpayer's receipt of its stock cannot be brought within the scope of Section 112(b)(3). The instant case presents, we believe, a situation which should be distinguished from the *Bus & Trans. Corp., Groman, Bashford, Lawrence* and *Anheuser-Busch* situations, because not to do so would completely lose sight of subordinate steps in the transaction herein which have a direct bearing on the true substance and ultimate result, within the rule of *Founders General Corp. v. Hoey,* 300 U. S. 268, 275. To say that substance prevails over form by considering the ultimate picture as between the Lawrence Barker interests and Lawrence Barker, Inc., to be the same as that involving stockholder, parent, and subsidiary is to take too superficial a view of what really happened in 1923 and 1924 herein to allow such an approach to be called the prevailing of substance over form. On the contrary, it allows appearances to subordinate the true result of the 1923 reorganization, which was to readjust in Barker California by reorganization the stock interests therein of its several stockholders.

It will not do, moreover, as might be argued, to say that the reorganization plan depended upon the participation of Lawrence Barker, Inc. The function of Lawrence

Barker, Inc., could as well have been performed whether it had been incorporated or not. Its creation or noncreation had no effect upon the rights of the stockholders as a group, as was true in the *Bus & Trans. Corp., Groman,* and *Bashford* line of cases. The creation of Lawrence Barker, Inc., served only the individual purposes of the several individuals composing Lawrence Barker interests, who were minority stockholders in both Barker California and Barker Delaware. Thus, further, is the situation at bar distinguished from that line of decisions.

C. Taxpayer Acquired His Stock in Lawrence Barker, Inc., as the Result of a Tax-free Reorganization, Within the Meaning of Section 202(c)(3) of the Revenue Act of 1921.

In the alternative, we argued below that taxpayer acquired his stock in Lawrence Barker, Inc., upon an exchange in which no gain or loss was to be recognized within the meaning of Section 112(b)(5) of the Revenue Act of 1934. This is similar not only to Section 112(b)(5) of the 1932 Act upon which taxpayer relies, but it is also similar in material respects to Section 202(c)(3) of the Revenue Act of 1921.

These sections provide that no gain or loss shall be recognized upon an exchange where one or more persons transfer property to a corporation and immediately thereafter are in control thereof, provided that if two or more persons are involved the stock or securities of such corporation received upon the exchange are in substantially the same proportion as their interest in the property transferred to it. Section 202(c)(3) defines control as the ownership of 80 per cent or more of all the voting stock and 80 per cent of all other classes of stock. Section 112(h) of the 1934 Act and Section 112(j) of the 1932 Act similarly provide.

It is to this aspect of the problem that taxpayer directs his brief, relying only upon the proposition that taxpayer did not own the requisite percentage of shares of stock in the transferee corporation. At the outset, it is well to state that the fact that Section 202(c)(2) of the 1921 Act or Section 112(b)(3) of the Revenue Acts of 1932 and 1934 may be applicable herein does not foreclose application of the provisions of Section 202(c)(3) of the 1921 Act or Section 112(b)(5) of the Acts of 1932 and 1934. The provisions of the two subsections of Section 112(b) are complementary and frequently overlap. *Helvering v. Cement Investors*, 316 U. S. 527; *Skouras v. Commissioner*, 45 B. T. A. 1024, appeal dismissed, August 17, 1942 (C. A. 9th). And, while customarily the application of Section 112(b)(5) or Section 202(c)(3) redounds to a taxpayer's benefit, it may be applied, as in the case herein, to his detriment. *Portland Oil Co. v. Commissioner*, 109 F. 2d 479 (C. A. 1st), certiorari denied, 310 U. S. 650.

With respect to the applicability of Section 202(c)(3)[3] taxpayer defines the issue herein (Br. 20) as whether the Barker California stockholders—

> after the 1923 exchange whereby all the common stockholders of California exchanged their stock for 95,697 shares of Delaware stock, said California stockholders were in "control" of Delaware so as to constitute the transaction a tax-free exchange within the meaning of Section 112(b)(5).

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[3]For clarity, we shall confine our discussion on this question to the terms of Section 202(c)(3), although it is equally applicable to Section 112(b)(5) of the Acts of 1932, 1934, and, in fact, the present terms of the Internal Revenue Code.

By this statement and by the tenor of the entire argument of his brief, taxpayer apparently concedes that with regard to the question of control under the statute the intervention of the closely controlled Lawrence Barker, Inc., does not have any bearing upon the case.

Such a concession is, we submit, entirely correct. For purposes of Section 202(c)(2), we have discussed the problem above, because of an apparent conflict with the *Bus & Trans. Corp., Groman,* and *Bashford* line of decisions. That argument, over and above taxpayer's concession, is equally applicable here. Similarly as with respect to Section 202(c)(2) recognition of Lawrence Barker, Inc., as the effective owner of stock in Delaware perverts the substance of the 1923 transactions which were intended to reorganize Barker California and the respective stock interests of its several stockholders. Thus, laying aside for a moment taxpayer's complaint with respect to a binding obligation to sell stock to Bankers, the existence or non-existence of Lawrence Barker, Inc., was unimportant to the reorganization plan relative to Barker California and Barker Delaware.

The substantial result of the reorganization plan was that the stockholders of Barker California transferred their stock therein to Barker Delaware, in exchange for which they received stock in Barker Delaware. Taxpayer and his associates in the Lawrence Barker interests chose to hold their Delaware stock through Lawrence Barker, Inc. Insofar as the reorganization plan was concerned, the transfer of stock in Barker Delaware was in no way con-

nected with the reorganization nor with the readjustment of stock interests of the several stockholders in Barker California. The cases taxpayer cites in his brief (pp. 23-30) refer to binding obligations to transfer, in accordance with a plan, stock received by a transferor, resulting in decisions that since the transferor's possession was transitory it could not be considered possession coupled with control within the meaning of Section 202(c)(3).

As we have argued above, we believe this case should be approached by considering the separate steps herein, because of the basic importance of the reorganization of Barker California. Because of the importance of that plan, further, we believe the obligation upon the Lawrence Barker interests and Lawrence Barker, Inc., to transfer a portion of their shares to Bankers must be considered a part of another transaction, for the obligation to sell shares to Bankers was not a part of the reorganization plan. It was merely a step in an unrelated liquidation by the Lawrence Barker interests of a portion of their stock assets. This factor presents, we contend, a distinction between the facts herein and those in *Bassick v. Commissioner,* 85 F. 2d 8 (C. A. 2d), certiorari denied, 299 U. S. 592; *Commissioner v. Schumacher Wall Bd. Corp.,* 93 F. 2d 79 (C. A. 9th); and *Hazeltine Corp. v. Commissioner,* 89 F. 2d 513 (C. A. 3d), all cited by taxpayer in his brief.

Thus, insofar as the reorganization of Barker California and the transfer of its stock were concerned, taxpayer and his associates in the Lawrence Barker interests and the majority stockholders, or C. H. Barker interests, con-

trolled Barker Delaware immediately after the transfer to it of Barker California stock, within the meaning of Section 202(c)(3). The obligation of the Lawrence Barker interests and Lawrence Barker, Inc., to transfer a part of their subsequently received Barker Delaware first preferred was an obligation independent of and foreign to the reorganization of Barker California.

But, in any event, if because of the binding obligation of the Lawrence Barker interests and through them of Lawrence Barker, Inc., to transfer Barker Delaware first preferred to Bankers be recognized as cutting into the percentage of stock which they may be said to control, taxpayer's argument loses sight of the fact that there was an obligation to sell only 10,870 shares to Bankers. Bankers offered to buy such an amount [R. 58] and the offer was accepted [R. 63]. In addition, Bankers held an option to purchase an additional 10,000 shares. It makes no difference for present purposes that they exercised the option. The option is, after all, nothing more than a continuing offer to sell. Until it is accepted, there is no contract of sale. If the prospective purchaser holds only an option, not until that option is exercised does he become in any way in control of its subject matter. *Lawler v. Commissioner,* 78 F. 2d 567 (C. A. 9th); *Helvering v. Bartlett,* 71 F. 2d 598 (C. A. 4th); *Milwaukee Mechanics' Ins. Co. v. B. S. Rhea & Son,* 123 Fed. 9 (C. A. 8th). And an outstanding option against a transferor under Section 112 (b)(5) does not affect his control of stock received in the corporation to which he transferred property. *Commissioner v. First Nat. Bank,* 104 F. 2d 865, 871 (C. A. 3d).

Cf Helvering v. San Joaquin Co., 297 U. S. 496. Accordingly, until Bankers exercised their option, the Lawrence Barker interests through Lawrence Barker, Inc., retained control of the 10,000 shares which were the subject of the option within the meaning of Section 112(b)(5). *Cf. Wilgard Realty Co. v. Commissioner,* 127 F. 2d 514 (C. A. 2d), certiorari denied, 317 U. S. 655. See also *Pacific Refrigerating Co. v. Commissioner,* 100 F. 2d 30 (C. A. 9th); *Portland Oil Co. v. Commissioner, supra; Schmieg, Hungate & Kotzian, Inc. v. Commissioner,* 27 B. T. A. 337. Until the option was exercised, recognizing *arguendo* that the obligation to transfer 10,870 shares to Bankers existed, the original stockholders in California controlled all but 10,870 shares out of 95,679 shares of Barker Delaware outstanding immediately after the transfer of Barker California stock to it, considerably more than the requisite 80 per cent.

Conclusion.

The instant case presents peculiar facts, and may in some ways resemble other cases on the nonrecognition of gain or loss. But in this sector of the statute, obviously each case must be considered on its own facts. *Pacific Refrigerating Co. v. Commissioner, supra.* A reading of the agreement preceding the adoption of a plan of reorganization [R. 45-50] and of the reorganization plan itself [R. 51-56] in the light of relevant provisions of Section 202(c) of the Revenue Act of 1921 suggests that the parties certainly intended a tax-free exchange. *E. g.,* a reorganization upon a transfer of stock for stock was

planned, and planned as a reorganization. Moreover, Barker California stock was to be transferred for Barker Delaware stock so that [R. 52] "each stockholder of the California corporation will have the same proportionate stockholdings in the Delaware corporation as he now has the California corporation."

Under these circumstances, and in view of the foregoing, we submit that the decision of the District Court is correct and should be affirmed.

Respectfully submitted,

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APPENDIX.

Internal Revenue Code:

SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

(a) *Basis (Unadjusted) of Property.*—The basis of property shall be the cost of such property; except that—

* * * * * * * *

(6) [as amended by Sec. 213 of the Revenue Act of 1939, c. 247, 53 Stat. 862, and Sec. 121(c) of the Revenue Act of 1943, c. 63, 58 Stat. 21] *Tax-free exchanges generally.*—If the property was acquired, after February 28, 1913, upon an exchange described in section 112(b) to (e), inclusive, or Section 112(1), the basis (except as provided in paragraphs (15), (17), or (18) of this subsection) shall be the same as in the case of the property exchanged, decreased in the amount of any money received by the taxpayer and increased in the amount of gain or decreased in the amount of loss to the taxpayer that was recognized upon such exchange under the law applicable to the year in which the exchange was made. If the property so acquired consisted in part of the type of property permitted by section 112(b) or Section 112(1), to be received without the recognition of gain or loss, and in part of other property, the basis provided in this paragraph shall be allocated between the properties (other than money) received, and for the purpose of the allocation there shall be assigned to such other property an amount equivalent to its fair market value at the date of the exchange. Where as part of the consideration to the taxpayer another party to the exchange assumed a

liability of the taxpayer or acquired from the taxpayer property subject to a liability, such assumption or acquisition (in the amount of the liability) shall, for the purposes of this paragraph be considered as money received by the taxpayer upon the exchange. This paragraph shall not apply to property acquired by a corporation by the issuance of its stock or securities as the consideration in whole or in part for the transfer of the property to it.

* * * * * * * *

(12) *Basis established by Revenue Act of 1932.*— If the property was acquired, after February 28, 1913, in any taxable year beginning prior to January 1, 1934, and the basis thereof, for the purposes of the Revenue Act of 1932, 47 Stat. 199, was prescribed by section 113(a)(6), (7), or (9) of such Act, then for the purposes of this chapter the basis shall be the same as the basis therein prescribed in the Revenue Act of 1932.

* * * * * * * *

(16) *Basis established by Revenue Act of 1934.*— If the property was acquired, after February 28, 1913, in any taxable year beginning prior to January 1, 1936, and the basis thereof, for the purposes of the Revenue Act of 1934 was prescribed by section 113(a)(6), (7), or (8) of such Act, then for the purposes of this chapter the basis shall be the same as the basis therein prescribed in the Revenue Act of 1934.

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(26 U. S. C. 1946 ed., Sec. 113.)

Revenue Act of 1921, c. 136, 42 Stat. 227:

SEC. 202. BASIS FOR DETERMINING GAIN OR LOSS.

* * * * * * * *

(c) For the purposes of this title, on an exchange of property, no gain or loss shall be recognized unless the property received in exchange has a readily realizable market value; but even if the property received in exchange has a readily realizable market value, no gain or loss shall be recognized.

* * * * * * * *

(2) When in the reorganization of one or more corporations a person receives in place of any stock or securities owned by him, stock or securities in a corporation a party or resulting from such reorganization. The word "reorganization," as used in this paragraph, includes a merger or consolidation (including the acquisition by one corporation of at least a majority of the voting stock and at least majority of the total number of shares of all other classes of stock of another corporation, or of substantially all the properties of another corporation), recapitalization, or mere change in identity, form, or place of organization of a corporation, (however effected); or

(3) When (A) a person transfers any property, real, personal or mixed, to a corporation, or (B) two or more persons transfer any such property to a corporation, and immediately after the transfer are in control of such corporation, and the amounts of stock, securities, or both, received by such persons are in substantially the same proportion as their interests in the property before such transfer. For

the purposes of this paragraph, a person is, or two or more persons are, "in control" of a corporation when owning at least 80 percentum of the voting stock and at least 80 per centum of the total number of shares of all other classes of stock of the corporation.

Revenue Act of 1932, c. 209, 47 Stat. 169:

SEC. 112. RECOGNITION OF GAIN OR LOSS.

* * * * * * * *

(b) *Exchanges Solely in Kind.*—

* * * * * * * *

(3) *Stock for stock on reorganization.*—No gain or loss shall be recognized of stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization.

* * * * * * * *

(i) *Definition of Reorganization.*—As used in this section and sections 113 and 115—

(1) The term "reorganization" means (A) a merger or consolidation (including the acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation, or substantially all the properties of another corporation), or (B) a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor or its stock-

holders or both are in control of the corporation to which the assets are transferred, or (C) a recapitalization, or (D) a mere change in identity, form, or place of organization, however effected.

(2) The term "a party to a reorganization" includes a corporation resulting from a reorganization and includes both corporations in the case of an acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation.

* * * * * * * *

SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

(a) *Basis (Unadjusted) or Property.*—The basis of property shall be the cost of such property; except that—

* * * * * * * *

(6) *Tax-free exchanges generally.*—If the property was acquired upon an exchange described in section 112(b) to (e), inclusive, the basis shall be the same as in the case of the property exchanged, decreased in the amount of any money received by the taxpayer and increased in the amount of gain or decreased in the amount of loss to the taxpayer that was recognized upon such exchange under the law applicable to the year in which the exchange was made. If the property so acquired consisted in part of the type of property permitted by section 112(b) to be received without the recognition of gain or loss, and in part of other property, the basis provided in this paragraph shall be allocated between the properties (other than

money) received, and for the purpose of the allocation there shall be asisgned to such other property in amount equivalent to its fair market value at the date of the exchange. This paragraph shall not apply to property acquired by a corporation by the issuance of its stock or securities as the consideration in whole or in part for the transfer of the property to it.

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Revenue Act of 1934, c. 277, 48 Stat. 680:

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SEC. 112. RECOGNITION OF GAIN OR LOSS.

(b) *Exchanges Solely in Kind.*—

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(5) *Transfer to corporation controlled by transferor.*—No gain or loss shall be recognized of property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation, and immediately after the exchange such person or persons are in control of the corporation; but in the case of an exchange by two or more persons this paragraph shall apply only if the amount of the stock and securities received by each is substantially in proportion to his interest in the property prior to the exchange.

* * * * * * * *

(h) *Definition of Control.*—As used in this section the term "control" means the ownership of at least 80 per centum of the voting stock and at least 80 per centum of the total number of shares of all other classes of stock of the corporation.

* * * * * * * *

SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

(a) *Basis (Unadjusted) of Property.*—The basis of property shall be the cost of such property; except that—

* * * * * * * *

(6) *Tax-free exchanges generally.*—If the property was acquired, after February 28, 1913, upon an exchange described in section 112(b) to (e), inclusive, the basis shall be the same as in the case of the property exchanged, decreased in the amount of any money received by the taxpayer and increased in the amount of gain or decreased in the amount of loss to the taxpayer that was recognized upon such exchange under the law applicable to the year in which the exchange was made. If the property so acquired consisted in part of the type of property permitted by section 112(b) to be received without the recognition of gain or loss, and in part of other property, the basis provided in this paragraph shall be allocated between the properties (other than money) received, and for the purpose of the allocation there shall be assigned to such other property an amount

equivalent to its fair market value at the date of the exchange. This paragraph shall not apply to property acquired by a corporation by the issuance of its stock or securities as the consideration in whole or in part for the transfer of the property to it.

* * * * * * * *

Treasury Regulations 62, promulgated under the Revenue Act of 1921:

Art. 1566. *Exchange of property which results in no gain or loss.*—Where property is exchanged for other property, even if the property received in exchange has a readily realizable market value, no gain or loss is recognized:

* * * * * * * * *

(b) When in the reorganization of one or more corporations a person receives in place of any stock or securities owned by him, stock or securities in a corporation a party to or resulting from such reorganization. The word "reorganization" as used in this paragraph includes a merger or consolidation (including the acquisition by one corporation of at least a majority of the outstanding voting stock and at least a majority of the total number of outstanding shares of all other classes of stock of another corporation), recapitalization, or mere change in identity, form, or place of organization of a corporation, however effected. Under this paragraph it makes no difference whether the stock or securities received are or are not of a like kind or class. So long as the property received in the reorganization consists of stock or securities within the usual meaning and acceptation of these

terms, no gain or loss is recognized. Where two or more corporations unite their properties, by either (1) the dissolution of corporation B and the sale of its assets to corporation A, or (2) the sale of its property by B to A, or (3) the sale of the stock of B to A, or (4) the merger of A of a majority of the voting stock and a majority of the total number of shares of all other classes of stock of B or of substantially all of the properties of B, no taxable income is received from the transaction by A or B or by the stockholders of either corporation A or corporation B, provided the sole consideration received by the stockholders is stock to or resulting from the reorganization. Where in connection with an internal adjustment of the affairs of a corporation, either by recapitalization or a change in identity, form, or domicile (however effected), a person receives in place of the stock or securities owned by him new stock or securities of the corporation, no gain or loss is realized. In this connection, see article 1568.

(c) When (A) a person transfers any property, real, personal, or mixed, to a corporation, and immediately after the transfer is in control of such corporation, or (B) two or more persons transfer any such property to a corporation, and immediately after the transfer are in control of such corporation, and the amounts of stock, securities, or both, received by such persons are in substantially the same proportion as their interests in the property before such transfer. For the purposes of this paragraph, a person is, or two or more persons are, "in control" of a corporation when owning at least 80 per cent of the outstanding voting stock and at least 80 per cent of the total number of outstanding shares of all other classes of stock of the corporation.

Examples.—(1) A and B each own an undivided one-half interest in certain property. Corporation X is created, to which A and B transfer the property, each receiving in exchange therefor 50 per cent of the stock of the corporation X. No gain or loss is realized from this exchange.

(2) A, who owns common stock in the X corporation of the par value of $70,000, transfers certain property to the corporation, for which he received additional common stock of the par value of $15,000. The X corporation has outstanding immediately after the transfer only common stock of the par value of $100,000. No gain or loss is realized from this exchange.

(3) A owns certain property which he transfers to the corporation X, a going concern, in which he owns common stock of the par value of $280,000 and class A non voting preferred stock of the par value of $70,000. The X corporation immediately after the transfer has outstanding common stock of the par value of $400,000, class A non-voting preferred stock of the par value of $25,000. No gain or loss is realized from this exchange.

(4) A owns certain property which he transfers to corporation X, a going concern, in which A owns no stock, in exchange for common stock of the corporation of the par value of $170,000. The X corporation has outstanding immediately after the transfer common stock of the par value of $200,000 and non voting preferred stock of the par value of $50,000. A realized a gain or loss from this exchange measured by the difference between the basis of the property exchanged and the fair market value, if readily realizable, of the stock received in the exchange. If the property exchanged was acquired prior to March 1, 1913, see article 1561.

Treasury Regulations 111, promulgated under the Internal Revenue Code:

SEC. 29.113(a)(6)-1 [as amended by T. D. 5402, 1944 Cum. Bull. 229]. *Property Acquired Upon a Tax-Free Exchange.*—In the case of an exchange, after February 28, 1913, of property solely of the type described in section 112(b) or (1), if no part of the gain or loss was recognized under the law applicable to the year in which the exchange was made, the basis of the property acquired is the same as the basis of the property transferred by the taxpayer with proper adjustments to the date of the exchange.

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SEC. 29.113(a)(12)-1. *Basis of Property Established by Revenue Act of 1932.* Section 113(a)(12) provides that if the property was acquired, after February 28, 1913, in any taxable year beginning prior to January 1, 1934, and the basis of the property, for the purposes of the Revenue Act of 1932, was prescribed by section 113(a)(6), (7), or (9) of that Act, then for the purposes of the Internal Revenue Code the basis shall be the same as the basis therein prescribed in the Revenue Act of 1932.

* * * * * * * *

SEC. 29.113(a)(16)-1. *Basis of Property Established by Revenue Act of 1934.*—Section 113(a)(16) provides that if property was acquired after February 28, 1913, in

any taxable year beginning prior to January 1, 1936, and the basis of the property for the purposes of the Revenue Act of 1934 was prescribed by section 113(a)(6), (7), or (8) of that Act, then for the purposes of the Internal Revenue Code the basis shall be the same as the basis therein prescribed under the Revenue Act of 1934. For example, if after December 31, 1920, and in any taxable year beginning prior to January 1, 1936, property was acquired by a corporation by the issuance of its stock or securities in connection with a transaction which is not described in section 112(b)(5) of the Code but which is described in section 112(b)(5) of the Revenue Act of 1934, the basis of the property so acquired shall be the same as it would be in the hands of the transferor, with proper adjustments to the date of the exchange.